California Agriculture:

1996 Agenda for Tax Reform

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Dean Andal was elected to the Board of Equalization in 1994 to represent the Second District which includes the Central Valley, Inland Empire, and the Central Coast of California.

Dean began his public service as an assistant to then Congressman Norm Shumway (R-Stockton).

As President of Andal Communications, a Stockton based marketing company, Dean has acquired valuable insight into the burdensome regulations and excessive taxation inflicted on California business.

Prior to his election to the Board of Equalization, Dean served as a Member of the California State Assembly for two terms. He represented the 17th Assembly District which encompasses Stockton and most of San Joaquin County. During his tenure in the Assembly, Dean served as a member of the influential Revenue and Taxation and Ways and Means Committees, was honored by major taxpayers rights groups as Taxfighter of the Year for 1992, and served as the Chief Republican Budget Negotiator for the 1993-94 session. Among Dean s most fulfilling accomplishments was the enactment of the trigger mechanism in the 1994-95 budget, which requires across the board spending cuts in state government in the event state revenues fail to meet projections.

Since his election to the State Board of Equalization in 1994, Dean has implemented an intensive office consolidation within the 28 counties he represents. To date, he has closed 14 offices generating over $40 million dollars in savings for California taxpayers.

Dean and his wife Kari reside in Stockton with their young son, Patrick. An Eagle Scout, Dean continues to be active in Scouting.

California Agriculture: An Agenda for Tax Reform presents key tax issues which must be addressed in order to secure a healthy economic future for business in our state.

I. WHAT S WRONG?

Agriculture has been the backbone of California s economy from the time it was settled in the early 1800 s. Since that time Californians have found agri-business to be of major public importance and have chosen to promote agricultural related business and have also taken steps to ensure the preservation and continued existence of farm lands. Among steps taken was the passage of the California Land Conservation Act, known as the Williamson Act, whose primary purpose is to encourage the preservation of farm land through reduced property tax burdens. The Legislature has also provided a sales and use tax exemption for the purchase of containers used in packaging food products.

Unfortunately, the Board of Equalization (BOE) has been interpreting and implementing these two vital provisions in such a way that they have become ineffective at achieving their intended objectives. Although the Williamson Act was intended to reduce the tax burden on agricultural land, the BOE has set the risk rate component in calculating the capitalization rate in such a way that effectively ensures that Prop. 13 values will often be less than under the Williamson Act.

Current practices by some County Assessors in valuing open-space land tend to favor using the projected income from an agricultural use which may yield higher values for the land than would the present use of the property. These practices present a formidable obstacle in achieving the express goals of the Williamson Act to encourage the preservation, conservation, and continued existence of agricultural and open-space lands.

The Board of Equalization staff has narrowly interpreted the sales and use tax exemption which applies to packaging materials to exempt only containers used by those who grow and pack their own food products. The effect of this interpretation is that if growers (owners) package the food product themselves, the exemption applies. However, if they hire someone to package their food products, the exemption does not apply. By so severely limiting this exemption, the BOE has created an unequal playing field for packaging companies in California based on a criteria that has no merit.

II. THE SOLUTION.

A. INCREASE RISK RATE.

Revise the Assessors Handbook to provide for a base risk rate of not less than 2% and adjust the risk rates for share rent and owner-operator income accordingly.

B. IMPROVE HIGHEST & BEST USE DEFINITION.

Revise the Assessors Handbook to include definitions that make the appraisal of open-space land less subjective, factors that must be considered in determining whether to value open-spaced land at other than the present use, and factual examples demonstrating when the Assessor should or should not accept the present use as the highest and best use.

C. EXEMPT ALL FOOD CONTAINERS FROM TAX.

Amend Sales and Use Tax Regulation 1589, Containers and Labels, which officially interprets Section 6364 of the Revenue and Taxation Code, to add the following sections: **(B)** Nonreturnable containers when sold without the contents to persons who place food products for human consumption in the containers for subsequent sale.

III. WILLIAMSON ACT: RISK RATE, HIGHEST & BEST USE.

A. INTRODUCTION.

In 1965, the Legislature enacted the California Land Conservation Act, also known as the Williamson Act. The purpose of the Williamson Act is to encourage the preservation, conservation, and continued existence of agricultural and open-space lands. The primary incentive is a property tax reduction. The Legislature assumed that the reduction of property tax on these lands would ease the pressures upon landowners to convert their land to urban and industrial development.

In 1966, one year after passage of the Williamson Act, California s voters approved Proposition 3 which granted the Legislature the authority to depart from market value assessment of enforceably restricted open-space lands. In 1967, legislation was enacted that prohibited local assessors from the use of comparable sales data in the valuation of open-space lands subject to enforceable restrictions and to assess these lands on an income method approach.

Under the Williamson Act Program, landowners may enter into ten year rolling contracts with participating cities and counties to restrict their lands to agricultural or open space uses. In exchange, landowners are taxed preferentially, based on the actual, rather than the speculative, use of their land.

Proposition 13: In 1978, the voters enacted Proposition 13 which provided property tax relief. Proposition 13 overhauled the property tax system by converting the current value method to an acquisition value system, and limiting the tax rate to 1% (plus special district tax rates).

When Proposition 13 was first implemented its base-year concept was applied to open-space properties. This concept resulted in a significant reduction of the tax benefit provided by the Williamson Act. The Legislature responded with a statute that provided that Proposition 13 could only be applied when the base-year value is lower than the value based upon the restricted use of the property and the current fair market value.

B. VALUATION OF OPEN-SPACED LAND SUBJECT TO AN ENFORCEABLE RESTRICTION.

The method used for valuation of open-spaced land is provided by Rev. & Tax. §423. The income approach is the basic appraisal method applicable to the valuation of open-space land subject to an enforceable restriction under the Williamson Act. Generally, under the income approach the value of property is determined by dividing the income generated by the land by the capitalization rate. The statute limits the annual income to be capitalized and specifies the capitalization rate to be used.

Rev. & Tax. §423(d) provides that the taxable value of open-space land shall be the lower of (1) the restricted value under the income approach; (2) the current fair market value which the property would bring if exposed for sale in the open market; and (3) the factored base-year value under Proposition 13.

C. RISK COMPONENT OF THE CAPITALIZATION RATE.

1. The Statute Provides A Formula That Increases The Capitalization Rate In Order To Reduce The Taxable Value Of Property.

My analysis will focus on the capitalization rate because this is where both the problem and solution lie. The value of property is directly related to the capitalization rate. The higher the capitalization rate, the lower the value of the property, and vice versa.

The capitalization rate provided by the statute is the sum of four components: (1) an interest component; (2) a risk component; (3) a property tax component; and (4) a component for amortization of any investment in perennials. Section 423 prescribes that the interest component shall be the yield for long-term United States government bonds. The present interest component is 7%.

2. *The BOE s Narrow Measure Of The Risk Rate Component Effectively Overrules Section 423(B)(2).*

The risk component is a percentage determined on the basis of the location and characteristics of the land, the crops to be grown thereon and the provisions of any lease or rental agreement to which the land is subject. The Assessors Handbook published by the BOE on The Valuation of Open-Space Property suggests that appraisers use a risk rate component between .25% and 1.0%, based upon the type of income generated.

With the present interest component of 7% and a property tax component of 1%, a .25% increase in the risk rate component only decreases the value of the property by about 2.75%. Thus, the BOE suggests a de minimus risk rate component which effectively overrules the provision in the statute and has little effect on the value of the property. This guideline by the BOE undermines the legislative intent to provide a tax benefit as an incentive to enroll property under the Williamson Act.

There have been many fundamental changes in the nearly 30 years since the enactment of the Williamson Act which increased risks. In terms of the statute, these risks would be associated with the location and characteristics of the land . One such risk involves concerns about the environment including contamination, endangered species, and the protection of plant and animal species. Another relatively recent risk development surrounds the availability and quality of water. A large decrease in the availability of financing for agricultural property is yet another important risk now associated with the ownership of agricultural lands. These risks materially increase the cost of owning land, curtail the uses to which the land can be put, and reduce the market value of the land.

The handbook states that the suggested risk rate range is meant to serve only as a guide. We are aware of several county assessors who have in the past or currently use a risk rate component higher than that suggested in the handbook. The BOE in its surveys has been unnecessarily critical of the assessors that have deviated from the suggested risk rate component. These assessors properly adjusted the risk rate to recognize the additional risks that face agri-business.

I find part of the problem within the risk rate component. More importantly, this is where the simplest solution lies. I propose that the BOE change the guidelines given to the local assessors and suggest that the risk rate component range should be as follows:

Type of Income	Current Suggested Risk Component	Proposed Suggested Risk Component
Cash Rent	**0.25%**	**2.00%**
Share Rent	**0.50%**	**2.25%**
Owner-Operator Income	**1.00%**	**2.75%**

The handbook should continue to suggest that the risk rate range is meant to serve only as a guide and that the risk component should be increased when above normal risks exist. The handbook should also suggest that the risk rate range should not be below 2%.

A 2% and 2.75% risk rate component decreases the value of the property by about 15% and 21%, respectively, assuming the interest component remains at 7%. Such a change would give back to the agricultural landowners the tax benefit that was lost when Proposition 13 was enacted and would encourage enrollment and renewal of acreage under the Williamson Act.

It may be argued that the risk is included in the income component because many of the risks are considered when the amount of rent is negotiated between the landowner and tenant. The Legislature clearly provided for the capitalization rate to include a risk component that may also be reflected in the negotiated rent.

Section 423(b)(2) provides that the risk component shall be determined on the basis of the location and characteristics of the land, the crops to be grown thereon, and the provisions of any lease or rental agreement to which the land is subject. These are the exact same components that one looks to in determining the amount for which land should lease. The Legislature intended to give landowners a material benefit and allow for the risks to be reflected in both the rent and risk rate computation.

3. The Legislature Mandated Risk Rate Components Of 2% And 4% In A Similar Incentive For Historical Property.

My suggestion of a risk rate component of at least 2% is based on a similar provision for property under a historical property contract. Rev. & Tax. §439.2 provides a very similar formula for the computation of the capitalization rate for historic property. The formula includes an interest component based on a Federal mortgage rate, a historic property risk component of 4% for owner-occupied single family dwellings and 2% for other historic property, a component for property taxes, and an amortization component.

The only significant difference between the capitalization computations for open-space property and historical property is the risk rate component. In the case of historical property, the Legislature mandated a 2% or 4% risk rate, while in the case of open-space property, the BOE effectively nullified the legislative intent by suggesting a risk rate component between .25% and 1%.

4. Conclusion.

Throughout the 1980 s interest rates were high compared to interest rates at the time of enactment of the Williamson Act and today. The high interest rates resulted in high capitalization rates because of the interest component. The loss of tax benefits from the narrow interpretation of the risk rate component went relatively unnoticed because the high capitalization rate kept property values down. Now that interest rates are reduced, landowners have clearly noticed the loss of tax benefits.

Often the Proposition 13 valuation is lower than the Williamson Act valuation resulting in no tax benefit for agricultural and open-space

property. If a solution is not sought landowners will no longer have an incentive to keep acreage enrolled or to renew acreage already enrolled. My proposal that the risk rate component be changed is a simple and practical solution.

The voters provided a tax incentive to promote the conservation, preservation, and continued existence of open space lands in 1966, well before Proposition 13. The Legislature passed statutes to enable the voters intent. Proposition 13 did not repeal Section 8 of Article XIII, and should not serve to reduce or eliminate this tax incentive. Our proposal does not change the law but merely puts the BOE s improper and narrow interpretation of the risk rate in line with the intent of the voters of California and the Legislature.

D. HIGHEST AND BEST USE.

1. The Statute Uses Subjective Terms Permitting Significant Interpretation And Nonuniform Appraisal Judgment.

As discussed above, the income approach is the basic appraisal method applicable to the valuation of open-space land subject to an enforceable restriction under the Williamson Act.

Rev. & Tax. §423(a) provides guidance under which the annual income to be capitalized is calculated. The income shall be the fair rent when sufficient rental information is available. This fair rent shall be the same as the amount for which comparable lands have been rented in the area, considering the terms and conditions of typical land leases in the area and enforceable restrictions imposed. The income shall be the amount that can reasonably be expected to be yielded under prudent management when sufficient rental information is not available. The enforceable restrictions imposed must also be considered.

The revenue used to determine the income shall be the amount which the land can be expected to yield to an owner-operator annually on the average from any use of the land permitted under the terms by which the land is enforceably restricted. When the land is planted to fruit-bearing or nut-bearing trees, vines, bushes, or perennial plants, the revenue shall not

be less than the land would yield to an owner-operator from other typical crops grown in the area during a typical rotation period.

Thus, the calculation of the income and revenue is largely driven by the statute, but leaves a significant amount of room for the use of professional appraisal judgment.

These statutes leave the appraiser in the position of subjectively determining several potential issues including: (1) what comparable lands have been rented for; (2) what comprises a typical land lease in the area; (3) what constitutes prudent management; (4) what the land can be expected to yield to an owner-operator from any permitted use of the land under the contract; (5) what the land would be expected to yield from other typical crops grown in the area during a typical rotation period; (6) what constitutes a typical crop grown in the area; and (7) what is a typical rotation period.

2. *The Statute Provides A Rebuttable Presumption That The Present Use Is The Highest And Best Agricultural Use.*

Rev. & Tax. §430 provides that there shall be a rebuttable presumption that the present use of open-space land which is enforceably restricted and devoted to agricultural use is its highest and best agricultural use. Despite the subjective nature of the statutes, the Assessor must be able to overcome this rebuttable presumption. In other words, the Assessor must prove that the present agricultural use is not the highest and best use. The vague and subjective terms of Rev. & Tax. §423(a) are the tools the Assessor may use to overcome the presumption. For example, the Assessor must prove that the property is not prudently managed or that other typical crops grown in the area would result in a higher yield during a typical rotation period.

3. *The Handbook Should Provide Guidance Regarding The Factors The Assessor Must Prove To Overcome The Rebuttable Presumption.*

The current handbook states that this presumption is not difficult to rebut under certain conditions and that there are many borderline situations

where appraisal judgment will be required. The statute, however, provides a rebuttable presumption in favor of the present agricultural use. This clearly indicates that the Legislature intended that the present use be accepted as the highest and best agricultural use, unless the Assessor can prove otherwise.

The handbook should be drafted to strengthen this presumption and clearly state that the Assessor can overcome the presumption only when a preponderance of the facts prove that the present use is not the highest and best agricultural use. The handbook could do this with definitions of the subjective terms described above and factual examples.

4. Conclusion.

A situation that demonstrates the controversy involved in this area was brought to my attention. A Brussels sprout grower in California had the value of his restricted land valued based upon what the yield would have been if he had grown strawberries. Because strawberries yield more income than Brussels sprouts, this land was valued at a value that the farmer thought was unfair and unreasonable. Although I am not aware of the details involved in this appraisal, it seems to me that the it should not be too easy for the Assessor to successfully overcome the rebuttable presumption provided in the statute by the Legislature. The revised handbook should provide additional guidance for both the agricultural community and the Assessor in order to alleviate such seemingly unfair and unreasonable appraisal practices.

IV. SALES AND USE TAX EXEMPTION FOR CONTAINERS.

A. INTRODUCTION.

Section 6364 of the Revenue and Taxation Code reads as follows:

> There are exempted from the taxes imposed by this part, the gross receipts from sales of and the storage, use or other consumption in this State of:
>
> (a) Nonreturnable containers when sold without the contents to persons who place the contents in the container and sell the contents together with the container.
>
> (b) Containers when sold with the contents if the sales price of the contents is not required to be included in the measure of the taxes imposed by this part.
>
> (c) Returnable containers when sold with the contents in connection with a retail sale of the contents or when resold for refilling.
>
> As used herein the term returnable containers means containers of a kind customarily returned by the buyer of the contents for reuse. All other containers are nonreturnable containers.

In a recent sales and use tax audit of a major manufacturer of packaging materials, the BOE auditor assessed tax on packaging materials sold by the manufacturer, to companies who pack food products for farmers. ***Staff treated the same packaging materials, when sold to a farmer who packages their own food products, as not subject to tax.***

This assessment was based on staff s ***interpretation*** of the exemption provided in Section 6364. Staff interpreted the exemption to apply only when the grower purchases the containers to package their own food products. In other words, if a grower packages their food items themselves, the exemption applies. However, if they hire someone else to package their food products, the exemption does not apply.

Because of the magnitude of the issue, many packing companies and farmers would be adversely effected if the staff s interpretation were upheld. In addition, the BOE s staff interpretation cannot easily be applied. There are many growers that package <u>both</u> food products that they own *and* food products owned by others. It becomes even more complicated when you take into account the various co-op s and commercial entities involved.

By limiting the exemption in this manner and basing the taxation of packaging containers on <u>who</u> is doing the packaging, not on <u>what</u> is being packaged, the BOE staff has created an unequal playing field for packaging companies in California.

B. THE SOLUTION.

Amend Sales and Use Tax Regulation 1589, *Containers and Labels*, which officially interprets Section 6364, to add the following section:

> (B) <u>Nonreturnable containers when sold without the contents to persons who place food products for human consumption in the containers for subsequent sale.</u>

Sales and use tax regulations are written and adopted as a means of interpreting the statutes. Currently, the BOE s regulation does not provide an exemption from tax for the sale of containers for use in packing food products owned by another and subsequently resold, unless title to the containers is passed to the owner of the food products prior to use by the packer.

C. BENEFITS OF REGULATION 1589 AMENDMENT.

The proposed amendment to Regulation 1589 will provide an equal playing field for all those in the fruit, vegetable and other exempt food product growing industry. It should not matter who is packaging the food products; all containers used to package food products should be treated the same, whether packaged by the farmer or by a packaging company hired by the farmer. These taxes which the BOE staff is proposing to assess against packaging companies, will ultimately be passed on to the growers, who in turn must either eat the cost of the tax or somehow pass it on to the ultimate consumer.

It was not the intent of the Legislature to tax containers used to package food products. Although BOE staff has chosen to interpret the statutes in that manner, I believe it is clear that these containers and packaging materials were meant to be excluded from sales and use taxes.

The California Grape & Tree Fruit League provided estimates for the fruit and vegetable industries alone, which indicate a total annual tax estimate

of $37,527,500 (approximately $500,367,000 in annual sales) which would be due the state, if our proposed amendment is not enacted.